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**UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA**

STEVE POIZNER, INSURANCE
COMMISSIONER OF THE STATE
OF CALIFORNIA, in his capacity as
Liquidator of Frontier Pacific Insurance
Company,

Plaintiff,

vs.

NATIONAL INDEMNITY
COMPANY, a Nebraska corporation;
and DOES 1 through 10,

Defendant.

Case No. 08 CV 772 L (POR)

Assigned to the Hon. M. James Lorenz
Courtroom 14

Complaint Filed: March 17, 2008

**DEFENDANT NATIONAL
INSURANCE COMPANY'S REPLY
TO OPPOSITION OF INSURANCE
COMMISSIONER**

DATE: August 18, 2008
TIME: 10:30 a.m.
COURTROOM: 14

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1 Defendant National Insurance Company ("NICO"), moving party
2 herein, presents the following reply to Plaintiff's Opposition to Motion To Stay
3 Prosecution of Action Pending Arbitration of Claims ("Opposition").

4 **I. THE OPPOSITION FAILS TO ADDRESS THE GROUNDS ON**
5 **WHICH AN INJUNCTION IS SOUGHT**

6 In its Motion To Stay Prosecution of Action Pending Arbitration of
7 Claims (the "Motion"), NICO advances the following propositions of fact and law
8 as justifying an order staying these proceedings pending arbitration:

9 (a) NICO and Frontier Pacific Insurance Company ("FPIC") are
10 parties to the Center Re Agreement and the NICO Agreement.

11 (b) The Center Re Agreement and the NICO Agreement both
12 provide for arbitration of all disputes in accordance with New York law.

13 (c) Prior to execution of Endorsement No. 3 to the Center Re
14 Agreement by NICO and Frontier Insurance Company ("Frontier"), FPIC and
15 Frontier were jointly and severally liable for repayment of a Funds Withheld
16 Balance due under the Center Re Agreement approximating \$40,000,000.

17 (d) The California Insurance Commissioner (the "Commissioner"),
18 as liquidator for FPIC, claims that FPIC is presently owed \$4,883,090 under the
19 NICO Agreement.

20 (e) NICO claims that it is entitled to set off the \$40,000,000 Funds
21 Withheld Balance due NICO under the Center Re Agreement against NICO's
22 alleged liability of \$4,883,090 under the NICO Agreement.

23 (f) Set off is recognized as an affirmative defense under New York
24 law. *Kivort Steel Inc. v. Liberty Leather Corp.*, 110 A.D.2d 950, 952, 487 N.Y.S. 2d
25 877 (1985).

26 (g) NICO's claim of set off exists independently of Endorsement
27
28

1 No. 3 and is not dependent on the terms of such endorsement.¹

2 (h) The Commissioner alleges that Endorsement No. 3 constitutes an
3 accord and satisfaction as to the liability of FPIC.

4 (i) Under New York law, accord and satisfaction is an affirmative
5 defense. *Mass v. Melymont*, 1 Misc. 3d 906A, 2003 WL 23138786 (N.Y. Dist. Ct.
6 2003).

7 (j) The Commissioner alleges that exercise of the proposed set off
8 by NICO is illegal, as in contravention of California Insurance Code section 1031.

9 (k) Illegality is an affirmative defense.

10 (l) An Agreement to arbitrate disputes under a contract requires
11 arbitration of affirmative defenses raised by any party. *Republic of Nicaragua v.*
12 *Standard Fruit Co.*, 937 F.2d 469, 478 (9th Cir. 1991) *cert. den.* 503 U.S. 919;
13 *Prima Paint Corp. v. Flood & Conklin Mfg.*, 388 U.S. 395, 404 (1967); *National*
14 *Union Fire Ins. Co. v. Belco Petroleum Corp.*, 88 F.3d 129 (2d Cir. 1996); and
15 *O'Neel v. NASD*, 667 F.2d 804, 807 (9th Cir. 1982).

16 (m) The fact that an affirmative defense may be predicated on an
17 agreement between one or more non-parties to the arbitration contract does not
18 exempt such affirmative defense from resolution through arbitration. *Local Union*
19 *No. 370, Intl. Union of Operating Eng. 'rs. v. Morrison-Knudson Co.*, 786 F.2d
20 1356, 1357-1358 (9th Cir.1986).

21 (n) Under controlling Ninth Circuit authority, California state
22 insurance law does not preempt the mandate of the Federal Arbitration Act to
23 submit to arbitration all claims by a liquidator for affirmative relief under contracts
24 providing for arbitration. *Quackenbush v. Allstate Ins. Co.*, 121 F.3d 1372, 1380-
25 1381 (C.A. 9th Cir., 1997), citing *U.S. Dept. of Treasury v. Fabe*, 508 U.S. 491,

26 ¹ NICO acknowledges that Frontier has the right under Endorsement No. 3 to
27 preclude exercise of the right of set off, but there is no allegation that such
28 prerogative has been exercised.

1 113 S.Ct. 2202 (1993); and *Bennett v. Liberty National Fire Ins. Co.*, 968 F.2d 969,
2 971-972.

3 Candor on the part of the Commissioner would have required a
4 forthright discussion as to the defect in any of these propositions. In point of fact,
5 the Opposition ignores or mischaracterizes virtually every tenet of the Motion, with
6 the exception of the issue of whether the McCarran-Ferguson Act effects a “reverse
7 preemption” of the Federal Arbitration Act. As to this point, the Opposition cites
8 distinguishable Fifth and Tenth Circuit authority, without acknowledging the
9 controlling authority of *Quackenbush v. Allstate Ins. Co.*, 121 F.3d 1372 (C.A. 9th
10 Cir., 1997) cited in the Motion.

11 **II. NICO’S CLAIM OF SET OFF IS NOT DEPENDENT ON**
12 **ENDORSEMENT NO. 3**

13 In both the Motion and its Answer to Complaint, NICO went to some
14 lengths to clarify that the rights of set off which it asserts arise under the Center Re
15 Agreement; NICO’s rights of set off are not alleged to be created or expanded by
16 Endorsement No. 3. (See Motion, Pg. 5, lines 27-28: “NICO denies that its claim
17 of set off arises under Endorsement No. 3.”) It is therefore perverse that the
18 Commissioner predicates the Opposition on the proposition that NICO is attempting
19 to enforce Endorsement No. 3! Without Endorsement No. 3, under the NICO
20 Agreement and the Center Re Agreements, NICO would enjoy the same common
21 law rights of set off which accrue in favor of any contracting party. It is the
22 Commissioner who chooses to make an issue of Endorsement No. 3, by alleging that
23 it constitutes an accord and satisfaction. While the Commissioner is certainly
24 entitled to argue this position, it is indisputably an affirmative defense to FPIC’s
25 liability under the Center Re Agreement and, by extension, an argument against set
26 off under the NICO Agreement. As such, the Commissioner is bound to arbitrate
27 this defense, as he would any other defense.

1 For the reasons stated, the Commissioner's suggestion that NICO is
 2 attempting to enforce arbitration of an agreement to which the Commissioner is not
 3 a party is unfounded. NICO is content to ignore Endorsement No. 3 in
 4 characterizing the scope of its rights of set off. The fact that the Commissioner
 5 wishes to rely on an agreement to which it was not a party (Endorsement No. 3) as
 6 the basis for an affirmative defense to the NICO Agreement and the Center Re
 7 Agreement does not vitiate the general rule that the affirmative defenses must be
 8 arbitrated. *See Local Union No. 370, Int'l Union of Operating Eng'rs v. Morrison-*
 9 *Knudson Co.*, 786 F.2d 1356, 1357-1358 (9th Cir. 1986).

10 **III. THE LIQUIDATION ORDER DOES NOT PROHIBIT ARBITRATION**

11 The Commissioner argues that the instant motion should be denied
 12 because the Liquidation Order and the statutes which authorize it prohibit "the
 13 institution or prosecution of any actions or proceedings." This argument fails at the
 14 most fundamental level: It is the Commissioner, not NICO, which has instituted this
 15 action. NICO has done nothing more than file a motion to stay prosecution. It
 16 follows that NICO is in violation of neither the Liquidation Order, nor the
 17 authorizing statutes. Moreover, as the holding in *Quackenbush, supra*, makes clear,
 18 the Federal Arbitration Act supercedes California state insurance codes, as well as
 19 court orders issued pursuant thereto.

20 **IV. THE MCCARRAN-FERGUSON ACT DOES NOT EFFECT A** 21 **REVERSE PREEMPTION OF THE FEDERAL ARBITRATION ACT** 22 **AS APPLIED TO CLAIMS FOR AFFIRMATIVE RELIEF BY A** 23 **LIQUIDATOR**

24 The Commissioner cites *Quackenbush v. Allstate Ins.* 121 F.3d 1372,
 25 1381 (9th Cir. 1997), *Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277
 26 (10th Cir. 1998), and *Munich Am. Reinsurance Co. v. Crawford*, 141 F.3d 585, 590-
 27 596 (5th Cir. 1998) for the proposition that a stay of litigation under state insolvency
 28 statutes reverse preempts the Federal Arbitration Act. The *Davister* and *Munich*

1 *America* courts have indeed so held under different circumstances: where a party
 2 adverse to the liquidator asserts an interest in property over which the insolvency
 3 court has exercised in rem or quasi in rem jurisdiction.² The holding in
 4 *Quackenbush, supra*, is narrower. In *Quackenbush*, Allstate moved the trial court
 5 for an injunction against continuance of proceedings in the California insolvency
 6 court intended to adjudicate its rights of set off. Allstate's motion was premised on
 7 the theory, *inter alia*, that such litigation undermined the jurisdiction of the federal
 8 court in the removal proceedings. The Court of Appeal upheld the trial court's
 9 discretion in refusing to issue an injunction, noting that a state court decision may or
 10 may not have preclusive effect.

11 The posture of the instant case is, of course, radically different. NICO
 12 is not seeking to enjoin state court litigation. It is the Commissioner, not NICO, that
 13 has sought affirmative relief in the federal court - - in effect seeking recovery of an
 14 allegedly past due balance in the amount of \$4,883,090. In circumstances such as
 15 this, where the Commissioner sought affirmative relief relating to contracts
 16 containing arbitration provisions, the *Quackenbush* court held that the
 17 Commissioner stood in the shoes of the insolvent and, like the insolvent, was bound
 18 to arbitrate his claims. *Quackenbush*, 121 F.3d at 1380. Similarly, the Court
 19 rejected the reverse preemption argument now advanced by the Commissioner,
 20 noting that "while the FAA might not mandate arbitration of Allstate's claims
 21 against Mission, it continues to apply with full force to Mission's claims (asserted
 22 by the Commissioner) against Allstate." In so doing the Court distinguished the
 23 matter before it from the holding of the U.S. Supreme Court in *U.S. v. Fabe*, 508
 24 U.S. 491, 501-502 (1993), noting the paucity of evidence that arbitration would
 25 disrupt the orderly liquidation of an insurer and that no California state insurance
 26

27 ² *Davister* concerned real property which was arguably part of the insolvency estate;
 28 *Munich America* concerned division of a cash corpus held by the liquidator.

1 code provision prohibits arbitration of disputes with a liquidator. *Quackenbush*, 121
2 F.3d at 1381.

3 The same factors militate here in favor of compelling arbitration: there
4 is no evidence to show that arbitration will be a slower or more costly means to
5 resolve the instant dispute than proceedings in this court.³ Neither has California
6 law changed since the holding in *Quackenbush*; the Commissioner cites no statute
7 prohibiting arbitration of disputes between a liquidator and third parties. This Court
8 is therefore fully justified in finding that the Federal Arbitration Act has not been
9 subject to reverse preemption.

10 **V. THE COMMISSIONER'S CLAIM THAT FPIC IS THE VICTIM**
11 **OF INEQUITABLE CONDUCT IS BOTH MISLEADING AND**
12 **IRRELEVANT; THE UNDERLYING CONTROVERSY IS NOT**
13 **IMPLICATED BY THIS MOTION**

14 The Commissioner argues that Endorsement No. 3 threatens unfairly to
15 burden FPIC's estate in liquidation with liabilities created by Frontier. From the
16 perspective of NICO, this is a dispute to which it is a stranger. NICO in good faith
17 entered into reinsurance contracts under which Frontier and FPIC defined
18 themselves as a single entity, in legal effect rendering themselves jointly and
19 severally liable.⁴ In the Opposition, the Commissioner does not dispute such joint
20 and several liability. It was entirely fair for NICO to collect as much of the
21 indebtedness owed as it could from Frontier, while reserving the option to collect

22
23
24 ³ In the Opposition, the Commissioner cites a treatise for the proposition that
25 arbitration is expensive. This obviously is not evidence. There is no competent
26 showing that arbitration will be more expensive or slower than proceedings in this
27 court. Indeed, the ability to join Frontier in New York arbitration proceedings may
28 expedite a resolution through arbitration.

⁴ As remarked in Williston On Contracts (4th Ed.) §36:1 at p.610, "Copromissors
are liable 'jointly' if all of them have promised the entire performance which is the
subject of the Contract."

1 the balance from FPIC. Any issue of fairness is a matter for resolution between the
2 two insolvent estates - - not the basis for a defense against NICO.

3 However, more to the point, the arguments raised by the
4 Commissioner, if at all relevant, go to the merits of the underlying dispute. It is
5 settled law that, on motion to compel arbitration, a court is not to concern itself with
6 the merits of the underlying dispute. *O'Neil v. Hilton Head Hosp.*, (4th Cir., 1997)
7 115 F.3d 272, 275.

8 **VI. THE COURT SHOULD REJECT THE COMMISSIONER'S**
9 **INVITATION TO SEVER ISSUES THE COMMISSIONER MAY**
10 **DEEM NOT SUBJECT TO ARBITRATION**

11 In an effort to salvage some benefit from an opposition which consists
12 largely of "jousting at windmills," the Commissioner argues the Court should sever
13 some unidentified issues for retention and trial, while enjoining prosecution of
14 others. This argument flies in the face of the comprehensive scope of the arbitration
15 agreement at issue. The parties have bargained for submission of all issues to
16 arbitration and the Commissioner presents neither grounds, nor authority to deviate
17 from the comprehensive stay mandated by 11 USC § 3. See Motion, Pg. 7, lines 7-
18 17. Indeed, authority would appear to be to the contrary. See *Tepper Realty Co. v.*
19 *Mosaic Tile Co.*, 259 F.Supp. 688 (S.D.N.Y. 1966) (staying entire action,
20 notwithstanding Plaintiff's effort to split cause of action); and *Fox v. Merrill Lynch*
21 *& Co. Inc.*, 453 F.Supp. 561 (S.D.N.Y. 1978) (entire action stayed pending
22 arbitration, though antitrust issues deemed not arbitrable).

23 **VII. CONCLUSION**

24 The matter before the court is a simple one, when properly understood:
25 Is the Commissioner bound by the arbitration agreements entered into by FPIC,
26 which compel arbitration of disputes over enforcement of the subject reinsurance
27 agreements? The Court in *Quackenbush* at 1380 cites *Liberty Nat'l Fire Ins. Co.*,
28 968 F.2d 969, 972 (9th Cir. 1992) for the proposition that, "[B]ecause the liquidator,

1 who stands in the shoes of the insolvent insurer, is attempting to enforce [the
2 insolvent insurer's] contractual rights, she is bound by [the insolvent insurer's] pre-
3 insolvency [arbitration] agreements." No different rule should apply in the instant
4 case.

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6 DATED: August 11, 2008

MUSICK, PEELER & GARRETT LLP

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8
9 By: s/Richard S. Conn
Richard S. Conn
10 Attorneys for NATIONAL INDEMNITY
11 COMPANY
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PROOF OF SERVICE

STATE OF CALIFORNIA
COUNTY OF LOS ANGELES

I am employed in the County of Los Angeles, State of California. I am over the age of 18 and not a party to the within entitled action; my business address is One Wilshire Boulevard, Suite 2000, Los Angeles, California 90017-3383.

On August 11, 2008, I served the foregoing document(s) described as **DEFENDANT NATIONAL INSURANCE COMPANY'S REPLY TO OPPOSITION OF INSURANCE COMMISSIONER** on the interested parties in this action by placing a copy thereof enclosed in a sealed envelope addressed as follows:

See Attached List

☒ **BY MAIL.** I caused such envelope with postage thereon fully prepaid to be placed in the U.S. Mail at Los Angeles, California. I am "readily familiar" with the firm's practice of collection and processing correspondence for mailing. Under that practice, it would be deposited with the U.S. postal service on that same day with postage thereon fully prepaid at Los Angeles, California in the ordinary course of business. I am aware that on motion of the party served, service is presumed invalid if postal cancellation date or postage meter date is more than one day after date of deposit for mailing in affidavit.

☒ **BY ELECTRONIC MAIL OR ELECTRONIC TRANSMISSION.** Based upon the Court's order for mandatory e-filing, I provided the documents listed above electronically to the Court's website and thereon to those parties on the Service List maintained by that website by submitting an electronic version of the documents to the Court's website. The documents are deemed filed and served on the date that they were uploaded to the Court's website.

☐ **BY FACSIMILE TRANSMISSION.** I caused such document to be transmitted to the addressee(s) facsimile number(s) noted herein. The facsimile machine used complies with Rule 2003 and no error was reported by the machine. Pursuant to Rule 2008(e), I caused the machine to print a transmission record of the transmission, a copy of which is attached to this declaration.

Executed on August 11, 2008, at Los Angeles, California.

☐ (State) I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

☒ (Federal) I declare that I am employed in the office of a member of the bar of this Court at whose direction the service was made. I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

s/K. Slevcove
Kathleen Slevcove

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